The Meaning of the Troubles at Lloyd's

Richard E. Stewart

Lloyd's of London is the world's largest and, to outsiders, most mysterious insurance market. In a business generally regarded as dull, Lloyd's has enjoyed a reputation for glamour (Betty Grable's legs) and daring (moon shots).

But in the last few years Lloyd's has had, though hardly enjoyed, a different kind of publicity — exposures of funds diverted, profits and losses hidden, disgrace of grand figures and public recrimination.

In most of us is a secret inclination to delight in the discomfort of the rich, powerful and glamorous. It has been a terrific story.

Insurance is at the center of commerce and economic development. Reinsurance is the way huge exposures to property or liability loss are spread across the financial resources of the world. It does not so much involve personal insurance, where individual losses are small and can be borne by a single company. It involves the multibillion-dollar energy complexes, the billions to correct environmental damage and dangerous workplaces, the yet uncounted cost of paying victims of wonder drugs gone wrong. We may call that big business insurance, but it affects all of us as businessmen and businesswomen and as individual human beings.

Insurance deals with the bad side of good things. Many of the good things of modern life require huge investments, and when they go wrong they cause huge damage. Without insurance they would not get done. Without reinsurance they would not get insured.

Lloyd's is the world's largest and most important reinsurance market. Alternatives exist and are growing, but Lloyd's is still so big and so central that what happens there is of concern not only to insurance everywhere but to economic development and commerce everywhere as well.

The public troubles of Lloyd's began when Alexander & Alexander, a large and publicly held American broker, bought a large Lloyd's broker and underwriting manager. The new American parent conducted routine audits of the Lloyd's broker after the acquisition. These revealed the diversion of funds and hiding of profits and losses which then were reported to British and American authorities and to the public.

The great embarrassment began. It is not over but undoubtedly will forever alter one of the world's most important financial institutions. Not that Lloyd's would not have changed anyway, but the disclosures have compressed into half a decade changes which might have taken half a century. The new direction already is clear and worth understanding.

Lloyd's began as a coffeehouse. Its quaint origin is good to keep in mind. Lloyd's is a place, not an insurance company. At Lloyd's, in one vast "underwriting room," brokers carry insurance proposals (“slips”) around the hundreds of cubicles (“boxes”). In each box sits an underwriter and his assistants.

On any risk of consequence or difficulty, especially when seeking the first (“lead”) underwriter’s participation, an experienced broker will deal face to face with an underwriter recognized as an expert in that kind of risk. If the lead underwriter accepts a portion, other underwriters will be inclined to follow.

In this respect, Lloyd’s is the opposite of the typical insurance company or industrial corporation. In the room at Lloyd’s, the top people deal directly with each other. Senior brokers and senior underwriters make deals person to person, one at a time. Face-to-face dealing by people of intelligence, experience and long acquaintance is a highly efficient way of conveying information.

The underwriter at Lloyd’s accepts risks on behalf of syndicates of individuals (“names”). The underwriter is usually a name in the syndicates for which he underwrites, but most of the resources behind him come from others. Virtually none of the outside names watch the underwriter’s work regularly. They rely on his judgment, probity and professional expertise.

For centuries, Lloyd’s has been a marketplace with three participants — brokers, underwriters and names. The big transactions have been personal, and the people doing them have been very senior people deeply schooled in the traditions of the Lloyd’s room.

Until quite recently, the same individual could hold all three roles and also could own part of a company which shared in the risks. Traditionally the relationship between participants was an open and informed one of trust and self-restraint. Rules were few. Crucial matters were governed by shared understanding. The people who mattered knew each other and knew how things ought to be done.

This sounds like a definition of a club. It is. Clubs are also small. Lloyd’s was small. Three centuries old in 1948, Lloyd’s still had only 2422 names. Participation was a privilege not widely shared and certainly not promoted. For example, only male British subjects were eligible to be names. Lloyd’s was a place, on the club model, where a small number of small businesses did very profitable business with each other. Nifty, but it couldn’t last.

The economic recovery that followed World War II generated huge demands for insurance since the need for insurance closely follows economic activity, growth and the accumulation of wealth. To continue to fulfill its role as the center of world reinsurance, Lloyd’s had to grow too. Premiums rose from $190 million in 1946 to $820 million in 1966 and to $5.5 billion in 1980. The number of names grew too. Eligibility was opened up in the late 1960s and early 1970s, first to foreigners, then to women. The “member’s agent” took a prominent role, recruiting those who, shortly before, had pleaded to join. By 1966 there were 6062 names, and by 1982 the number had risen to 21,601.

Still the informality of the club persisted. It was assumed that everybody would understand how things were done, that everybody would make money but not overreach, that the potential for conflict of interest was obvious but limited and would not be exploited.

Growing Pains

Anyone who has managed a business with an informal, collegial style through a period of rapid growth in volume and participation does not need to be told what was around the corner. Looking back, there were premonitory signs. In the 1970s, Lloyd’s was a victim of some tattered insurance scams, generally involving skimming of premium through repeated reinsurance transactions, leaving the last underwriter (in the best known case, a Lloyd’s syndicate named Sasse) holding the bag of a lot of risk for a little premium.

Some of the masterminds behind the scams were Americans whose insurance licenses had been revoked long before in the more structured and governmentally regulated U.S. market. In retrospect, the message was that Lloyd’s could be penetrated by unscrupulous people.

In the late 1970s, several Lloyd’s syndicates collectively lost hundreds of millions of dollars by guaranteeing the residual value of mainframe computers when they came off lease. It was a silly bet against IBM’s ability to obsolete its own product line. More significantly, it was a bet against one of Lloyd’s few formal and long established rules — no financial guarantees. Again in retrospect, the message was that Lloyd’s was not enforcing its own rules on the conduct of its own members even in the hallowed room itself.

From those two public episodes, plus others which were “contained,” the Lloyd’s establishment drew the accurate conclusion that the club style and mingled roles of the old, small Lloyd’s might no longer suffice. In 1980, a respected special commission issued the Fisher Report, which reached two principal conclusions.

The first conclusion was that Lloyd’s needed to act more like a financial institution and less like a place which once served coffee. It led to the creation of the Council of Lloyd’s, most of whose members actively or passively participate in the Lloyd’s market. It was a move toward formal self-regulation. The second conclusion was that Lloyd’s most obvious potential conflict, the common control of broking and underwriting, had to be solved structurally by separating the two kinds of firms. Based on the report, Parliament enacted the Lloyd’s Act of 1982, putting into effect those two recommendations.

Significant Moves

The Fisher reforms, together with the quality of the people chosen to implement them, are important changes in the governance of Lloyd’s and, hence, significant moves in the general world of insurance. But we should keep in mind that the Fisher Report and the events leading to it occurred before the disclosures from the Alexander & Alexander acquisition and audit.

The pre-Fisher disclosures were of abuse of common control of brokers and underwriters — an abuse of underwriters both at Lloyd's and, through reinsurance, elsewhere. The later, or post-Fisher, disclosures were of underwriters' siphoning profitable premiums out of their syndicates and into reinsurers they themselves owned — an abuse of trust and of outside investors.

It is widely expected that a forthcoming report by Lloyd's and a report to be completed this summer by the UK government Board of Trade will expose other practitioners of the lurid abuses. The Inland Revenue also is studying the tax-avoidance features of the schemes.

The lessons are clear and quite general: growth puts more stress on an organization than its insiders feel or respond to; handling other people's money imposes severer duties than handling one's own. Place temptation before a small group raised to resist it and they probably will, or at the very least they will expel from their club those who do not. Keep adding to the temptation and inviting people in and eventually some will embrace the temptation. A club rarely gets in trouble for secrecy; a public institution usually does. It pays to know which you are. These are not rules unique to Lloyd's. They are common principles of management, morals, politics, regulation and law enforcement.

Such common principles underlie what Lloyd's now is starting to do. Lloyd's has learned the hard way that it will have to become a more structured institution with more explicit rules, more disclosure and more independent regulation. It is implementing the lessons of the first, or broker-underwriter conflict, episode by moving away from clubbiness and toward formal and explicit self-regulation. What response will follow the second, or self-dealing, episode is still to be seen.

Once the officials of the UK government and of Lloyd's take the measure of the second problem, they may decide that self-regulation can handle it. Or they may decide that a further step is necessary, some measure of direct government regulation. The American experience is that direct economic regulation is no panacea. But the experience is also that self-regulation can dwindle into a transitional stage between independence and direct government involvement.

Future Choices

Just as Lloyd's immediate problems are not painless, its long-term choices are not easy. The direction of future change is clear — more rules protecting policyholders and names, rules enforcing fiduciary and disclosure principles, and rules guaranteeing the integrity of the insurance transaction. That much is inevitable. Rules, rules, rules. Does that mean it's all over for Lloyd's? Not at all. The necessary good can be done without sacrificing that which made Lloyd's great, though the dangerous pendulum effect of Lloyd's having stayed a club too long should not be underestimated.

Strong institutions profit from their mistakes. Lloyd's was strong long before it was an institution, back when it served coffee and left the business to the customers. Now it is going through a classic middle-size crisis, remarkable mainly because it was so long in coming.

The delay is proving expensive. But if the responsible officials respond with an eye to the long-term interests of the institution and its customers, the outcome should be a more efficient and dependable marketplace.

Lloyd’s old clubbiness may have permitted its greatness, but it did not cause that greatness. What made Lloyd’s great was inventiveness, the spirit of risk taking, the efficiency of risk spreading from a single place and the efficiency of professionals doing difficult transactions face to face. All those good things can still be done with a rulebook in the pocket expressing what was, in a simpler time, a code of honor carried only in the heart.